

## Internal Revenue Service

Number: **201026025**

Release Date: 7/2/2010

Index Number: 1001.00-00, 2501.00-00,  
2601.00-00

## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

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CC:PSI:04

PLR-147899-09

Date:

February 24, 2010

Re:

### Legend

Decedent =

State X =

Year 1 =

Spouse =

Child 1 =

Child 2 =

Child 3 =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Grandchild 4 =

Trust =

Charity 1 =

Charity 2 =

Year 2 =

Year 3 =

Greatgrandchild 1 =

Greatgrandchild 2 =

Greatgrandchild 3 =

Greatgrandchild 4 =

Greatgrandchild 5 =

Greatgrandchild 6 =

Greatgrandchild 7 =

Year 4 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Date 1 =

State Y =

Dear :

This responds to a letter dated August 19, 2009, and other correspondence, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed judicial construction of Trust to permit proposed sales of remainder interests in Trust.

### Facts

The facts submitted and representations made are as follows. Decedent, a resident of State X, died testate in Year 1, a date prior to 1969. Article Sixth of Decedent's will created Trust to benefit Child 1, Child 2 and his issue, Child 3 and her issue, and Spouse. Under the will, upon the termination of Trust, the trustee will distribute the corpus and undistributed income to Charity 1 and Charity 2. Trust will terminate upon the last to die of Spouse, Child 1, Child 2, Child 3, Grandchild 1, Grandchild 2, Grandchild 3, Grandchild 4, Greatgrandchild 5, Greatgrandchild 6, and Greatgrandchild 7. Spouse, Child 1, Child 2, and Child 3 are deceased. Child 2 had no issue. Child 3 is survived by Grandchild 1, Grandchild 2, Grandchild 3, and Grandchild 4 (collectively, Grandchildren) and eleven greatgrandchildren (collectively, Greatgrandchildren), which includes Greatgrandchildren 1 through 7. Under the will, Grandchildren and Greatgrandchildren are the current income beneficiaries of Trust. This private letter ruling request pertains to the proposed sales of interests in Trust by Greatgrandchild 1, Greatgrandchild 2, Greatgrandchild 3, and Greatgrandchild 4.

The will also contains a spendthrift clause which provides that:

each beneficiary hereunder is hereby restrained from anticipating, encumbering, alienating, or in any other manner assigning his or her interest or estate in either principal or income, and is without power to do so, nor shall such interest or

estate be subject to his or her liabilities or obligations, nor to judgment or other legal process, bankruptcy proceedings or claims of creditors or others. All income and principal, or either of them, shall be payable and deliverable only and personally to the respective beneficiaries entitled thereto.

In Year 3, pursuant to a Year 2 court order and Year 2 settlement among the parties, Charity 1 sold its remainder interest in Trust to Greatgrandchildren. For purposes of this ruling, after the sale, Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3 each owned a  $4 \frac{1}{6}$  percent remainder interest in Trust and Greatgrandchild 4 owned a  $12 \frac{1}{2}$  percent remainder interest in Trust. In Year 4, pursuant to a court order, Greatgrandchild 4 sold a  $2 \frac{1}{2}$  percent remainder interest in Trust to other relatives. The Year 4 court order stated that the spendthrift clause of Trust does not prohibit the sales because the clause applies only to beneficial interests arising under the terms of Decedent's will and does not apply to interests acquired after Decedent's death under the Year 2 settlement.

Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3 each propose to sell all or part of his or her  $4 \frac{1}{6}$  percent remainder interest in Trust to Trust 1, Trust 2, and Trust 3, respectively. Trust 1, Trust 2, and Trust 3 are trusts that were previously established by Grandchild 2 to benefit Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3, respectively. Greatgrandchild 4 proposes to sell all or part of her 10 percent remainder interest in Trust to Trust 4. Trust 4 was previously established by Grandchild 4 to benefit Greatgrandchild 4.

On the date of the proposed sales of the remainder interests in Trust, all of the assets of Trust will be marketable securities with the fair market value of the trust assets determined by prices listed on an established exchange. Each proposed seller intends to sell his or her remainder interest in Trust for a sales price equal to (i) the fair market value of Trust property as of the date of sale, multiplied by (ii) the § 7520 actuarial remainder factor then in effect, and multiplied again by (iii) the fraction representing the portion of the entire remainder subject to the sale. The purchase price will be paid to the respective Greatgrandchild in cash.

Under the terms of Trust 1, Trust 2, and Trust 3, each Greatgrandchild is the primary beneficiary of his or her respective trust during his or her life. Subject to certain withdrawal rights, each trustee may, in the trustee's uncontrolled discretion at any time or times and for any reason, pay any part of the income and principal of the trust to any among the primary beneficiary and the primary beneficiary's issue, whenever born. Moreover, the trustee may add the spouse of the primary beneficiary or the spouse of any of the primary beneficiary's issue to whom net income and/or principal may be paid. Any net income not distributed will be added to the principal of the trust. A primary beneficiary is granted a testamentary special power to appoint the trust property to any persons in a specified class. Trust 1, Trust 2, and Trust 3 will terminate, unless sooner terminated, upon the first to occur of the death of the primary beneficiary and all of his

or her issue whenever born, or the expiration of ninety years beginning on Date 1. Upon termination, the trustee shall distribute the remaining principal of the trust in accordance to the primary beneficiary's exercise of the special power of appointment or in default of such exercise, to the then living issue of the primary beneficiary, by right of representation. If there are no living issue of the primary beneficiary, then to the living issue of Grandchild 2, by right of representation.

Under the terms of Trust 4, Greatgrandchild 4 is the primary beneficiary of Trust 4 during her life. The trustee shall pay so much or all of the income and principal of a primary beneficiary's trust to the primary beneficiary for the health, support and maintenance in reasonable comfort, and education of the primary beneficiary during the primary beneficiary's lifetime. A primary beneficiary is granted a testamentary special power to appoint in trust that beneficiary's share to any persons and organizations in a specified class. Any part of that share the primary beneficiary fails to appoint will be divided per stirpes among the primary beneficiary's living descendants, or if none, then per stirpes among the living descendants of the nearest ancestor of the primary beneficiary who is a descendant of Grandchild 4 who has one or more descendants then living, or if also none, then per stirpes among Grandchild 4's then living descendants. If there are no living descendants of Grandchild 4, then the remaining trust assets will be distributed to a class of named nieces and nephews or charities as the trustee shall choose. Trust 4 is subject to State Y law which does not follow the common law rule against perpetuities.

It is represented that no additions, constructive or otherwise, have been made to Trust subsequent to September 25, 1985, and that, other than the earlier court order and settlement, Trust has not been amended or otherwise altered in any manner since September 25, 1985.

The trustee of Trust petitioned the appropriate court for an order that construes the spendthrift provision of Trust to permit the proposed sales. The court's order states that the spendthrift clause of Trust does not prohibit the proposed sales of the purchased remainder interests because the spendthrift clause does not apply to the interests acquired after Decedent's death under the Year 2 settlement, but only to beneficial interests arising under the terms of Decedent's will itself.

The trustee has requested the following rulings:

1. The court construction of the spendthrift clause and the provisions of Trust to allow the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.
2. The proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.

3. The proposed sales of remainder interests in Trust will not result in any taxable gifts for federal gift tax purposes as to the buyers or sellers of such interests.

4. The court approval of the proposed sales of remainder interests in Trust will not result in the recognition of gain or loss to Trust or any trust beneficiaries.

5. A gain or loss for each of the proposed sales will equal the difference between the amount realized for the remainder interest and the adjusted basis of the remainder interest.

### Law and Analysis

#### Rulings 1 & 2:

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer which includes under § 2611(a) a taxable distribution, a taxable termination, and a direct skip.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Under § 2652(a)(1), for purposes of chapter 13, the term “transferor” means the decedent, in the case of any property subject to tax imposed by chapter 11 and, the donor, in the case of any property subject to tax imposed by chapter 12. The individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property for purposes of chapter 13. Section 26.2652-1(a)(1) of the Generation-Skipping Transfer Tax Regulations. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the federal estate or gift tax applies. Section 26.2652-1(a)(2) provides that for purposes of chapter 13, a transfer is subject to federal gift tax if a gift tax is imposed under § 2501(a) (without regard to exemptions, exclusions, deductions, and credits).

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. Under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

In the present case, Trust is not subject to GST tax because it became irrevocable before September 25, 1985. It is represented that no additions, constructive or otherwise, have been made to Trust subsequent to that date.

The court construction of the spendthrift clause and the provisions of Trust to allow the proposed sales of remainder interests in Trust and the proposed sales of remainder interests in Trust will not shift any beneficial interests in Trust to a lower generation and will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, based upon the facts submitted and the representations made, and pursuant to § 26.2601-1(b)(4)(i)(D), we conclude that the court construction of the spendthrift clause and the provisions of Trust to allow the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes. Further, the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.

We note that, under § 2652(a)(1), Grandchild 2 is the transferor of Trust 1, Trust 2, and Trust 3 and Grandchild 4 is the transferor of Trust 4 for GST tax purposes.

### Ruling 3:

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

Under § 25.2512-5 of the Gift Tax Regulations, in general, the fair market value of remainders transferred by gift is the present value of the remainders determined by use of the appropriate § 7520 actuarial factor.

Section 7520(a) provides that the value of an annuity, any interest for life or a term of years, or any remainder interest or reversionary interest is determined under tables prescribed by the Secretary and by using an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the applicable federal midterm rate for the month in which the valuation date falls.

In the proposed sales of remainder interests in Trust, the sales price of the remainder interests will equal (1) the fair market value of Trust assets on the date of sale, (2) multiplied by the § 7520 actuarial remainder factor then in effect, and (3) then multiplied by the fraction representing that portion of the remainder interest subject to the sale. The sales price will be paid in cash. Based upon the facts submitted and the representations made, we conclude that the proposed sales of remainder interests in Trust will not result in any taxable gifts for federal gift tax purposes as to the buyers or sellers of such interests.

#### Ruling 4:

Section 61 provides that gross income means all income from whatever source derived. Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

An exchange of property results in the realization of gain or loss under § 1001 if the properties are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged participation interests in different loans. Id. In defining what constitutes a “material difference” for purposes of § 1001(a), the Court stated that properties are “different” in the sense that is material to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.

The issue for purposes of this ruling is whether the remaindermen of Trust would have the same property interests and legal entitlements as a result of the court's determination that the spendthrift clause does not prohibit the proposed sales of the remainder interests. It is represented that the court has entered a preliminary order determining that the spendthrift clause does not prohibit the proposed sales. The court's preliminary order becomes effective only upon the issuance of the requested letter ruling.

Because the court's construction of the spendthrift clause does not change the property interests and legal entitlements of the remaindermen, the court's construction of the spendthrift clause does not give rise to a realization of income to the remaindermen or Trust under §§ 61 or 1001.

#### Ruling 5:

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1001(e) provides that, in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such



interest which is determined pursuant to § 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. The term “term interest in property” means a life interest in property, an interest in property for a term of years, or an income interest in a trust.

Section 1.1001-1(f)(2) provides that the term “term interest in property” does not refer to remainder or reversionary interests in the property itself or other interests in property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest.

Section 1012 generally provides that the basis of property shall be the cost of the property.

Section 1.1012-1(a) defines cost to be the amount paid for the property in cash or other property. In the present case, Greatgrandchild 1, Greatgrandchild 2, Greatgrandchild 3, and Greatgrandchild 4 purchased their remainder interests in Trust from an unrelated third party, Charity 1. Consequently, under § 1012, the basis of each of their respective interests is the amount that each paid for the property. Each would recognize gain from the sale of the remainder interest equal to the difference between the amount realized over the adjusted basis of the remainder interest.

We express no opinion on whether the proposed sales are authorized under Trust or applicable state laws.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. The ruling(s) in this letter pertaining to the federal estate and/or generation-skipping transfer tax apply only to the extent that the relevant sections of the Internal Revenue Code are in effect during the period at issue.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Lorraine E. Gardner  
Senior Counsel, Branch 4  
(Passthroughs & Special Industries)

Enclosures (2)

cc: